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SUBJECT: AMBASSADOR'S FAREWELL CALL ON STATE MINISTER
BABACAN

1. (SBU) Summary: In a July 22 farewell call on State Minister Ali Babacan, Ambassador noted market concerns about delays in the IMF program and possible 2004 financing difficulties, and stressed the need for the GOT to move vigorously to complete the economic reform program. He also urged the GOT to promote the strongest possible business links with Iraq, noting that strong commercial ties could promote prosperity in both countries while also enhancing the security environment. Babacan emphasized the government's commitment to the reform program. He blamed delays in completing the Fifth IMF Review on the legislative process, but acknowledged that those delays -- combined with unhelpful talk about following the Malaysia model of working without the IMF -- had made markets nervous. He predicted growing market confidence into the Fall, and discounted rumors that Turkey would need additional financing, saying Treasury's debt rollover rate would actually decline significantly in the second semester. Babacan did not raise the issue of U.S. financial assistance. End Summary.

2. (SBU) Ambassador paid a farewell call July 22 on State Minister for the Treasury Ali Babacan, at the latter's request. Ambassador welcomed Turkey's good progress with the IMF in recent days, but noted that interest rates remained stubbornly high. He asked Babacan to comment on suggestions coming out of the Istanbul financial community that (a) the government is taking advantage of recent market buoyancy to slow the pace of reforms, and (b) there will be a need for additional financing come this Fall.

3. (SBU) Babacan responded that markets had been understandably nervous ahead of the Fourth Review, because the government was new, the number of prior actions was substantial, there were many disagreements between the GOT and Fund staff, and the specter of war in Iraq made it difficult to predict the economy's trajectory. In the case of the Fifth Review, however, there were few problems. The government believed in reforms, and certainly had not intentionally delayed completion of the review. Instead, the delay was the result of longer-than-expected parliamentary deliberations. The government did not want to intrude too aggressively into the parliamentary process, as it believed full deliberation and debate was healthy and would bring a sense of ownership to the Parliament. He added that Turkey had learned that rushing legislation -- such as the 15 laws in 15 days under Minister Dervis -- produced "defective" legislation that needed subsequent amendment. (Comment: In fact, the delay has been the result of GOT difficulties in agreeing to new fiscal measures, along with the slow legislative process.)

4. (SBU) Babacan agreed, nonetheless, that the delay in completing the review, combined with unhelpful comments about Turkey following the Malaysian model (i.e. not working with the IMF) had rattled the markets, which had prevented interest rates from falling as fast as he had hoped. Looking forward, however, he predicted market confidence would increase as the GOT moved ahead with the reform program. Ambassador asked if that meant the GOT would complete the Sixth and subsequent reviews more quickly; Babacan replied "I guess so."

5. (SBU) Babacan also discounted concerns about future financing, saying he saw no reasons for the markets to be nervous. He pointed out that the GOT and IMF had done a series of financial projections during recent discussions, and saw no financing gap going forward. In fact, the government expects to reduce its domestic debt rollover rate from 96 percent (for the first half of 2003) to 80 percent

(in the second half). He does not think the economy risks overheating, as domestic demand is moderate,

16. (SBU) On the fiscal side, Babacan said the government has agreed to measures to close the budget gap, projected at 0.7 percent of GNP. Eighty percent of the savings will come from the expenditure side, mostly via a reduction in public investment. The remainder will come from the revenue side. Babacan acknowledged that expenditures in the first semester had been higher than expected, while the much-touted tax amnesty had brought in considerably less than the GOT had hoped. Babacan indirectly chided Finance Minister Unakitan, saying his early, rosy estimates of significant additional revenue from the tax amnesty had led other ministers to rush to the Prime Minister with new spending projects. From now on, Babacan said, the GOT will have to be very careful on the fiscal side.

17. (SBU) Shifting to Iraq, Ambassador argued that Turkey had a great opportunity to build on historic and existing trade and assistance links to build a strong commercial relationship with the new Iraq, particularly the more stable, prosperous north. Already, the UN is shipping huge quantities of food and other supplies to Iraq, and U.S. forces there are buying millions of dollars worth of fuel and other items from Turkey. Unfortunately, some in Turkey were instead alleging that the U.S. and Turkey had conflicting security interests in Iraq, causing doubt and hesitation among Turkish business executives. Ambassador urged Babacan to work within the government in favor of an aggressive, business-oriented approach that would build prosperity on both sides of the border, which in turn would promote Turkey's security. Babacan agreed, and suggested that government needed only to stay out of the way of Turkish businessmen, removing any obstacles to trade and investment. Ambassador rejoined that a neutral government approach probably would not be sufficient; Turkey needed to actively promote full economic and commercial ties with the new Iraq.

18. (SBU) Of note, Minister Babacan did not raise the issue of U.S. financial assistance to Turkey.

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